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IN THE

Supreme Court of the United States

October Term, 1958.

No. 218.

EMORY W. PARSONS, ERMA M. PARSONS, et al.,
Petitioners,

v.

FRANCIS R. SMITH, Former Collector of Internal Revenue for the First District of Pennsylvania,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit.

BRIEF FOR THE PETITIONERS.

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FRANCIS R. SMITH, FORMER COLLECTOR OF INTERNAL REVENUE FOR THE FIRST DISTRICT OF PENNSYLVANIA,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR THE PETITIONERS.

OPINIONS BELOW.

Three cases, brought individually by three partners and their wives for refund of Federal income taxes, are before the Court in this proceeding. Since the cases involve identical issues, they were consolidated for trial before the United States District Court for the Eastern District of Pennsylvania and, upon appeal, were consolidated for hearing before the Court of Appeals. The findings of fact and opinion of the District Court (R. 7-29), which were not reported officially, are reported unofficially at 52 AFTR 1661. The opinions of the Court of Appeals affirming the District Court (R. 33-9) and denying petition for rehearing (R. 46-7) are reported at 255 F. 2d 595. Judge Kalodner dissented from the Court of Appeals' denial of the petition for rehearing, stating that his views are expressed at length in his dissenting opinion rendered in connection with the

Court of Appeals' denial of a petition for rehearing in *Huss v. Smith*.[1] Judge Kalodner's dissenting opinion in the *Huss* case, which was decided against the taxpayers in that case on the same day as the present case, is set forth in full in Appendix A, *infra*, page 23. This Court has granted a writ of certiorari in the *Huss* case, and has consolidated that case for argument with the present case.

JURISDICTION.

The judgments of the Court of Appeals (R. 39-41) were entered on March 27, 1958. The order of the Court of Appeals denying petition for rehearing (R. 47) was entered on May 29, 1958. The petition for a writ of certiorari was filed on July 25, 1958, and was granted on October 13, 1958 (R. 48). The jurisdiction of this Court is invoked under Section 1254(1) of the Judicial Code, 28 U. S. C. § 1254(1).

STATUTES.

In sum, the statutory provisions here involved provide for an income tax deduction for percentage depletion, in the case of coal mines, of 5% of the gross income received by a taxpayer from mining.[2]

The statutory provisions are Sections 23(m), 23(n) and 114(b)(4) of the Internal Revenue Code of 1939, 26 U. S. C. §§ 23(m), (n) and 114(b)(4). They are printed in Appendix B, *infra*, page 23.[3] The regulations involved are Treasury Regulations 111, 26 *Code Fed. Regs.* § 29.23(m)-1 (1949). They are printed in Appendix B, *infra*, page 28.

1. The opinions of the Court of Appeals in the *Huss* case affirming the District Court and denying petition for rehearing are reported at 255 F. 2d 599.

2. The taxable years in issue are 1945 through 1949. In the Revenue Act of 1951, the percentage rate for coal mines was increased from 5% to 10%, the current rate.

3. The provisions of the Internal Revenue Code cited are those applicable to the taxable years here involved. There has been no substantial change in those provisions affecting the question presented by this case. Compare Sections 611(a) and 613 of the Internal Revenue Code of 1954, 26 U. S. C. §§ 611(a), 613.

QUESTION PRESENTED.

A partnership ("miner") agreed with a landowner to prospect for and strip mine coal from his land, the entire cost of the operation to be borne by the miner. The owner agreed to pay the miner a stated price per ton for marketable coal which the miner discovered and extracted. The parties agreed that either could terminate the arrangement on ten days' notice, but in such event the miner would have the indefeasible right to remove and receive payment for all coal uncovered to the date of termination. After eight years of continuous stripping the arrangement was terminated by the miner.

The question is whether the Court of Appeals erred in holding that the miner had no economic interest in the coal it mined and was therefore entitled to no percentage depletion deduction, because its contract might have been terminated by the landowner and it was paid a stated price per ton of coal. It so held notwithstanding the fact (which the dissent below considered controlling) that the miner had the exclusive right to mine to exhaustion all coal uncovered by it, bore the entire cost of the enterprise, and was paid only for marketable coal discovered and delivered.

The United States (present here through a former Collector of Internal Revenue) is essentially a stakeholder in this proceeding. There is no dispute that an aggregate percentage depletion deduction is allowable, measured by the gross income derived from the property. The real question, therefore, is whether the landowner is entitled to the entire allowance or whether a portion of it should be allowed to the miner. Should the Court answer this question in favor of the miner, the owner would be required, in computing its depletion, to exclude from its gross income the amount paid to the miner. The miner in turn would measure its deduction by the amounts received from the owner. Thus, the decision in this case will determine only how the aggregate depletion allowance is to be shared.[4]

4. Similar considerations were present in *Commissioner v. Southwest Expl. Co.*, 350 U. S. 308 (1956), where both parties claiming the depletion allowance were before the Court at one time.

STATEMENT OF THE CASE.

The essential facts of this case may be summarized as follows:

During the taxable years in issue petitioners Emory W. Parsons, Howard H. Parsons and Lawrence H. Parsons were members of a partnership ("Parsons") [5] engaged in strip mining bituminous coal in Pennsylvania (R. 8, 11).

Petitioners brought suit upon rejected claims for refund of Federal income taxes. These claims were based upon the right of the partnership to a deduction for percentage depletion on amounts received by it during the taxable years for coal stripped under an oral agreement with Rockhill Coal Company ("Rockhill") (R. 8-11).

In March, 1942 Parsons and Rockhill entered into an oral salvage agreement under which Parsons agreed to strip mine land belonging to Rockhill at its own expense, and Rockhill agreed to pay a stated price per ton for marketable coal delivered (R. 13-15).[6] Under a salvage contract the stripper bears the entire cost of the operation, including normal operating expenses such as payroll, equipment rental, fuel and explosives, as well as the cost of grading and building roads and preparing tipple sites. He is paid, however, only if he is successful in discovering and extracting marketable coal. The landowner is required to pay only for marketable coal as it is delivered to him by the stripper (R. 15-18).

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5. The taxable years in issue are 1945 through 1949. Lawrence H. Parsons withdrew from the partnership effective December 31, 1948, and accordingly filed no refund claim for 1949. Emory W. Parsons and Howard H. Parsons continued the partnership during 1949.

6. According to the oral agreement, changes in the stated price per ton were to reflect only increases in wage or labor costs, but Rockhill also granted increases to compensate Parsons for increases in the cost of materials and explosives. These additional increases were in the nature of new oral agreements (R. 15-16).

Parsons' agreement was terminable by either party upon ten days' notice. It was also agreed that if Rockhill terminated the contract, Parsons had the right to remove and be paid for all uncovered coal, even though the removal required more than ten days (R. 13-14). Rockhill never exercised its right of termination, and Parsons continued to strip mine coal on Rockhill land until the fall of 1950 (R. 19, 24).

Parsons had the exclusive right, subject only to Rockhill's right of termination, to strip areas allocated to it (R. 15). These areas were selected by Rockhill's engineering department after consultation with Parsons and, generally, prospecting was sixty per cent successful (R. 18-19). On August 1, 1950, Parsons gave Rockhill notice that it intended to cease its operations, and Rockhill agreed that thirty days' notice would be satisfactory. Thereafter Parsons continued to strip mine coal that had been cleared of overburden until September 5, 1950, when no coal was left uncovered (R. 24).

The value of Parsons' equipment used in the operation ranged from $60,000 in 1943 to $250,000 in 1947. When Parsons ceased stripping on Rockhill land in 1950 it was utilizing equipment having a total value of $495,000, of which $125,000 was represented by its own equipment, and the balance by equipment leased from Rockhill (R. 21-22). Subject only to Rockhill's right of termination, Parsons controlled the size of the operation and the amount of coal mined (R. 14-15).

SUMMARY OF ARGUMENT.

I.

Parsons' right to depletion depends upon whether it acquired an economic interest in the coal in place. It did so under the decisions of this Court if (1) it acquired, by investment, an interest in the coal; (2) its income was dependent solely upon production; and (3) its interest was such that it declined in value as the coal was extracted.

The foregoing tests are met in the present case because (1) Parsons contributed to the enterprise its organization, know-how and equipment as operator, and by this investment acquired the right to mine the coal; (2) it received payment only for coal mined and delivered; and (3) the value of its right to mine coal declined as the coal deposit was depleted and less coal remained from which income could be realized.

As an entrepreneur assuming the risk of discovering and extracting a natural resource, by a contract under which it received no payment until it extracted and delivered marketable coal, Parsons is squarely within the class to which Congress intended depletion to be allowed.

II.

In denying the depletion deduction the Court of Appeals relied upon two factors: (1) Parsons' interest was terminable by either party; and (2) Parsons was paid a stated price per ton, irrespective of the market price. It mentioned a third factor: that Parsons' equipment was depreciable and suitable for other uses. None of these forecloses the existence of an economic interest.

1. Parsons had a valuable interest in the coal which Rockhill's right to terminate did not eliminate. The right to terminate in the future as to coal as yet undiscovered could not affect the existence of Parsons' economic interest in coal actually mined. In fact, as to coal uncovered Parsons' rights were nonterminable.

2. The depletion deduction is intended to compensate those who bear the risk of discovering natural resources. It is unnecessary that they also assume the risk of the market, a risk inherent in any enterprise conducted for profit and unrelated to production.

3. The third factor fails to comprehend the nature of Parsons' investment—the unlimited commitment of its entire organization as the operator, with the attendant financial risks. The Court below overlooked the elementary fact that all equipment used in developing natural resources (whether oil, gas or any mineral) is depreciable. If any other type of investment were required, no stripper operating under a stripping contract would have the requisite capital investment to support depletion.

ARGUMENT.

I.

Under the Principles Enunciated by This Court, Parsons Is Entitled to Depletion Deductions With Respect to Amounts Received for Coal Delivered to Rockhill During the Taxable Years in Question.

A. Introductory.

The sole issue in this case is whether the Court of Appeals erred in holding that Parsons, in computing its net income under the Internal Revenue Code,[7] was not entitled to deduct percentage depletion with respect to amounts received by it from Rockhill in payment for coal mined by it and delivered to Rockhill during the taxable years in question. Decision of this issue turns upon whether Parsons had an economic interest in the coal in place. *Kirby Petroleum Co. v. Commissioner*, 326 U. S. 599 (1946).

Although the right of a coal stripper to depletion has been the subject of extensive litigation in the lower courts, this Court has not passed upon the question. However, under principles announced by this Court in cases pertaining to depletion of oil and gas interests, it is now well established that a coal stripper can have an economic interest in coal sufficient to support a depletion allowance. The Courts of Appeals for both the Third and Fourth Circuits have so held where a miner was stripping coal under a contract on land belonging to another. *Commissioner v. Mammoth Coal Co.*, 229 F. 2d 535 (3d Cir. 1955), *cert. denied*, 352 U. S. 824 (1956); *Commissioner v. Gregory Run Coal Co.*, 212 F. 2d 52 (4th Cir. 1954), *cert. denied*, 348 U. S. 828 (1954). As the Fourth Circuit said in the *Gregory Run* case, 212 F. 2d at 61:

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7. Sections 23(m), 23(n) and 114(b)(4) of the Internal Revenue Code of 1939, printed in Appendix B, *infra*, page 28.

> "We think . . . the rights of the producers were completely dependent upon the extraction of the salable product and that consequently they were entitled to share in the benefits of the statute which were designed to give compensation to persons interested in the production of a wasting asset."

The Third and Fourth Circuits disagree, however, as to whether a stripper has an economic interest if the payments he receives from the landowner do not vary with the market or if the landowner has the right to terminate the stripping contract.[8] The issue in this case is whether the Court of Appeals for the Third Circuit erred in holding that Parsons did not have the requisite interest because of these two factors.

It is clear from this Court's decisions in the oil and gas cases that the two factors relied upon by the Court of Appeals are irrelevant, and that Parsons had an economic interest in the coal it stripped and is therefore entitled to the depletion deductions which it claims.

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8. The Fourth Circuit has held that these factors do not foreclose the existence of an economic interest. *Commissioner v. Gregory Run Coal Co.*, 212 F.2d 52 (4th Cir. 1954), *cert. denied*, 348 U. S. 828 (1954) (some of the contracts terminable on 30 days' notice; payment at a fixed price per ton); *Weirton Ice and Coal Supply Co. v. Commissioner*, 231 F.2d 531 (4th Cir. 1956) (contract terminable on 90 days' notice; payment at a fixed price per ton subject to adjustment for changes in labor costs); *Commissioner v. Hamill Coal Corp.*, 239 F.2d 347 (4th Cir. 1956) (contract terminable on 90 days' notice; payment at a fixed price per ton).

In *Usibelli v. Commissioner*, 229 F.2d 539 (9th Cir. 1955), the stripper operated under a terminable contract and was paid a fixed price per year for a fixed amount of coal to be mined. The Court held that the stripper had no economic interest. The *Usibelli* case is clearly distinguishable because the stripper was not dependent solely upon the production of coal for its income.

The Internal Revenue Service takes an arbitrary intermediate position and holds that the stripper has no economic interest if his contract is terminable upon less than one year's notice. G. C. M. 26290, 1950-1 C. B. 42.

B. *General Principles Relating to Depletion.*

The basic requirements of an economic interest were first announced by this Court in *Palmer v. Bender*, 287 U. S. 551 (1933), which held that the term "economic interest" does not mean title to, or ownership of, the mineral. On the contrary, it includes "every case in which the taxpayer has acquired, by investment, any interest in the [mineral] in place, and secures, by any form of legal relationship, income derived from the extraction of the [mineral], to which he must look for a return of his capital." 287 U. S. at 557.

"Investment" does not mean cost or cash outlay. Unlike depreciation, percentage depletion is not intended to return only cost, and the "allowance continues so long as minerals are extracted, and even though no money was actually invested in the deposit." The "investment" in the property is the contribution by the taxpayer of an asset essential to the mining enterprise. *Commissioner v. Southwest Expl. Co.*, 350 U. S. 308, 312 (1956).

The interest acquired by the taxpayer need not comprise ownership of the coal. A contractual right to mine the coal is sufficient. *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364 (1925). If the income derived from this interest is dependent solely upon production, the interest is an economic interest. It is the miner's "'possibility of profit' from the use of his rights over production, 'dependent solely upon the extraction and sale of the [mineral],' which marks an economic interest in the [mineral]." *Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. 25, 34-35 (1946).[9]

These principles were recently reaffirmed by this Court in *Commissioner v. Southwest Expl. Co.*, 350 U. S. 308 (1956). In that case an oil operator obtained a lease from

9. If the miner is not associated with production and does not contribute an asset essential to extraction of the mineral, he has only an "economic advantage", even though his payments may be dependent on production. *Helvering v. O'Donnell*, 303 U. S. 370 (1938); *Helvering v. Bankline Oil Co.*, 303 U. S. 362 (1938).

the State of California to drill for and produce oil from certain state lands lying off the coast of California. As required by state law, the operator obtained from adjacent upland owners the right to erect drilling equipment on their land, and by whipstock drilling from their land reached the oil deposit in the ocean. The operator agreed to pay the upland owners a stated percentage of its net profits for the use of their land. Unlike the usual case, the oil deposit did not lie beneath the land of the owners granting the right to drill. The question presented was whether the upland owners had an economic interest in the offshore oil and were therefore entitled to depletion on the net profits payments which they received. This Court held that they were entitled to depletion:

> "This contribution [of land] was an investment in the oil in place sufficient to establish their economic interest. Their income was dependent entirely on production, and the value of their interest decreased with each barrel of oil produced. No more is required by any of the earlier cases." 350 U. S. at 316.

C. *Parsons' Contribution to the Enterprise in Exchange for Which It Received a Right to Payments Based Upon Production Establishes Its Economic Interest.*

The basic requirements of an economic interest, first formulated in *Palmer v. Bender* and restated in the *Southwest* case, may be summarized as follows:

1) The taxpayer must acquire by investment an interest in the mineral in place;

2) The taxpayer's income must be dependent solely upon production of the mineral; and

3) The taxpayer's interest must decline in value as the mineral is exhausted.

1. The first of the Court's requirements is squarely met here. Parsons acquired, by its contract, a valuable interest in the coal in place—the right to mine it and be paid for it. This interest, like the contractual interest of the landowners in the *Southwest* case, was acquired by the investment of assets essential to the mining operation.

In the *Southwest* case the Court found that the land of the upland owners was essential to the drilling operation. "Without their participation there could have been no bid, no lease, no wells and no production." 350 U. S. at 315. The contribution of the use of their land to the venture in return for a contractual right to payments based upon production was "an investment in the oil in place sufficient to establish their economic interest." 350 U. S. at 316. No less essential to the production here was Parsons' investment in the venture of its entire organization, its know-how, and the stripping equipment. Without them no coal could be removed. If the contribution of land by an owner who has no other participation in the mining constitutes an economic interest, *a fortiori* the investment made by the operator himself must be sufficient.[10]

2. It is equally clear that the second requirement is met, for there can be no dispute that Parsons' income was dependent solely upon production. Under its salvage contract it could receive no payment whatever unless and until it discovered and produced marketable coal.

3. Finally, there can be no doubt that Parsons' interest in the coal progressively declined in value as the coal deposit was depleted. As each ton of coal was mined and

10. At the conclusion of its opinion in the *Southwest* case the Court cautioned that it did not have before it the case of a stranger "disassociated from the lease" who contributed a facility. 350 U. S. at 316-17. Nor does it here. Parsons, far from being a disassociated stranger, was itself the operator, the one to whom depletion deductions traditionally have been allowed. *E.g., Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312 (1934).

delivered to Rockhill, there remained that much less from which Parsons might thereafter realize income. Manifestly, therefore, the value of its contractual right to mine the coal decreased commensurately.

To paraphrase the words of this Court in the *Southwest* case:

> Parsons chose to contribute its organization and equipment to the coal stripping venture in return for income based on production. This contribution was an investment in the coal in place sufficient to establish its economic interest. Its income was dependent entirely on production, and the value of its interest decreased with each ton of coal produced. No more is required by any of this Court's decisions.

D. *Parsons Falls Squarely Within the Class of Taxpayers to Whom Congress Intended to Give the Depletion Allowance.*

The principles developed by this Court in allowing depletion to those who search for mineral deposits in return for income based upon production implement the intent of Congress in enacting the depletion provisions of the internal revenue laws. It is common knowledge that Congress intended by these provisions to stimulate the development of natural resources and compensate the operator for the risks inherent in his business. References to this purpose in Congressional debates and reports are numerous.[11] Illustrative is an exchange between the Honorable John Nance Garner, Congressman from Texas, and Mr. A. W. Gregg, Solicitor of Internal Revenue, during

11. *E.g., Hearings Before the Senate Finance Committee,* 65th Cong., 2d Sess. 44; S. Rep. No. 617, 65th Cong., 3d Sess. 6; *Discussion Before the House,* 65 Cong. Rec. 2799-2800; *Hearings Before the House Committee on Ways and Means,* 69th Cong., 1st Sess. 164; H. R. Rep. No. 1, 69th Cong., 1st Sess. 6; *Discussion Before the House,* 67 Cong. Rec. 774; S. Rep. No. 27, 69th Cong., 1st Sess. 3; *Discussion Before the Senate,* 78 Cong. Rec. 6182-83.

hearings before the House Ways and Means Committee leading to the Revenue Act of 1926, in which percentage depletion was first enacted as an administrative substitute for discovery value depletion. Mr. Garner propounded the following question to Mr. Gregg:

> "Was not one of the reasons given at the time, and which has been urged by a great many gentlemen throughout the country, that the discovery depletion was given to induce people to discover minerals and other things hidden in the earth, and that, it being a hazardous undertaking, where great losses were incurred by gamblers, if I may term them such, or the business men who indulged in it, that you gave them this deduction to encourage them to go into the earth and discover these minerals and oil? Was not that one of the reasons given?"

Mr. Gregg replied:

> "That was one of them; yes, sir. The other reason was that this was a very hazardous industry, which suffered great losses and made great gains, and that when they made these gains there should be some offsetting return because of the previous losses." *Hearings Before the House Committee on Ways and Means*, 69th Cong., 1st Sess. 164.

Similarly, in the Senate debate preceding enactment of the Revenue Act of 1934 the Honorable Thomas P. Gore, United States Senator from the State of Oklahoma, explained the purpose of discovery value depletion as follows:

> "Mr. President, the object of that legislation was to enable a man, particularly the wildcatter and the pioneer, when he was fortunate enough to discover an oil well, fortunate enough to discover an oil field, fortunate enough to serve society and himself, to have some concession based upon the nature of his industry

and the character of his risk; so it did provide that depletion might be based upon discovery value.

• • •

"I had a good deal to do with that legislation. I know the reasons which inspired it. I know that business cannot succeed unless some allowance of that sort i ade. If we destroy these venturesome spirits, then we turn industry over to the larger concerns which can take the risk when that risk becomes indispensable to their survival; but as long as they can they will remit that risk and shift it to the wildcatter and the pioneer." 78 Cong. Rec. 6182-83.

Parsons falls squarely within the class of taxpayers to whom Congress intended to give the depletion allowance, and to whom this Court has consistently allowed it in the past. Parsons committed its entire business operation to finding and extracting coal, bore the entire cost of the enterprise, and received no payment unless it found and extracted marketable coal. To it must belong the compensation provided by Congress for entrepreneurs who prospect for and produce minerals at the risk of losing their entire investment if they are unsuccessful. Parsons committed its know-how, payroll and equipment on the gamble that marketable coal might be discovered and exploited. It is the dedication of assets to an enterprise in search of natural resources, in precisely this fashion, which Congress sought to encourage.

II.

The Court of Appeals Erroneously Applied the Governing Principles of Law Announced by This Court.

The reasons given by the Court of Appeals for its conclusion that Parsons had no economic interest in the coal represent an erroneous application of the principles governing depletion announced by this Court.

The reasons assigned by the Court of Appeals may be summarized as follows:

(1) Parsons' contract was terminable by either party upon ten days' notice;

(2) Parsons was paid a stated price per ton of coal mined, irrespective of the market price; and

(3) Parsons' commitment of its capital was not "real and unequivocal" because its equipment was depreciable and suitable for another use.

A. *The Fact That Parsons' Contract Was Terminable by Rockhill Upon Ten Days' Notice Is of No Importance, and in Any Event Parsons Had the Right to Mine to Exhaustion All Coal Which It Uncovered.*

The Court of Appeals relied upon the fact that the contract between Parsons and Rockhill might have been terminated by either party on ten days' notice. This factor clearly has no relevance to a determination of the existence of an economic interest.

In the *Southwest* case the rights of the upland owners were terminable at the will of the operator, who could, without obligation to the landowners, modify or surrender its state lease.[12] Indeed, both the Tax Court and the Court of Appeals, in erroneously concluding that the upland owners had no economic interest, assigned as one of their reasons the fact that the upland owners' agreement might be terminated:

> "It would seem that the above-mentioned agreements could be terminated or modified at any time petitioner's agreement with the State of California was so terminated or modified. Under these circumstances it

12. The contract between Southwest (the operator) and the upland owners provided, *inter alia*, that "Southwest may, at any time, at its election, without any consent or participation by Second Parties [the landowners], modify said State Easement or surrender, and terminate the same in accordance with the provisions thereof." *Southwest Expl. Co. v. Commissioner*, 18 T. C. 961, 969 (1952).

would appear that the upland drill sites and the agreements granting them to petitioner could be abandoned and terminated by petitioner at any time the State of California might see fit to change its policy toward drilling in the submerged coastal lands." 220 F. 2d at 62, quoting 18 T. C. at 975.

In reversing the lower courts and holding that the upland owners possessed an economic interest, this Court simply said that "none of these possibilities occurred." 350 U. S. at 316.

Reliance on the terminability feature of Parsons' contract placed the Court of Appeals for the Third Circuit squarely in conflict with the decisions of the Court of Appeals for the Fourth Circuit holding that a termination provision in a stripper's contract does not deprive him of an economic interest. *Commissioner v. Hamill Coal Corp.*, 239 F. 2d 347 (4th Cir. 1956); *Weirton Ice and Coal Supply Co. v. Commissioner*, 231 F. 2d 531 (4th Cir. 1956); *Commissioner v. Gregory Run Coal Co.*, 212 F. 2d 52 (4th Cir. 1954), *cert. denied*, 348 U. S. 828 (1954). In the *Weirton* case the Fourth Circuit said:

"No stronger proof that Weirton had in effect the right to mine the coal could be found than in its willingness to invest $500,000 in the enterprise. *It is of no moment that the owner of the mineral, as in other cases in which the right of an extractor to a deduction for depletion has been upheld, had the option to terminate the arrangement at any time, for as the event proved, Weirton actually mined the coal during all of the taxable years.* We think that Weirton's rights were dependent solely upon the extraction and delivery of the coal, and that the relationship of the parties to the ore in place gave it an economic interest in the mineral and entitled it to share with National [the owner] the depletion allowance provided by the statute." 231 F. 2d at 535-36. (Emphasis added.)

The decisions of the Court of Appeals for the Fourth Circuit are correct and in accord with reality. Since Parsons obtained an interest in the coal through its contract with Rockhill, and since its income was dependent entirely upon production, it had an economic interest in all the coal which it in fact mined. Of necessity, therefore, Rockhill's right to terminate the contract as to coal as yet undiscovered and unmined has no relevance.

Judge Kalodner, in his dissent below in the *Huss* case, put his finger on the irrelevance of terminability when he said (*infra*, Appendix A, page 25):

> "I agree with the view of the Fourth Circuit that the right of termination does not affect a stripper's right to depletion where the requisite economic interest as defined by the Supreme Court exists. The Commissioner and the courts must deal with a situation as it exists during the taxable year involved and not as it might exist in some future year because of the possible occurrence of an event through the exercise of a contractual right." 255 F. 2d at 602.

An examination of the principle underlying depletion demonstrates inescapably that terminability cannot affect the existence of an economic interest. The realization of income from the extraction of natural resources necessarily results in the gradual exhaustion of the mineral deposit. Congress has therefore permitted a deduction for depletion so that part of the value of the mineral deposit may be recouped free of tax concurrently with the exhaustion of the deposit. Under this statutory scheme of depletion an economic interest, to be depletable, must be one which diminishes in value as the mineral is extracted.

It is at once apparent that the existence of a right of termination can have no effect upon the progressive diminution in value resulting from extraction. The value of *any* stripper's interest, whether terminable or not, declines as the coal is extracted. Any stripper will ultimately recover

only a certain amount of coal from a coal deposit. This amount cannot be determined precisely until the stripper removes his last ton of coal, either because the coal is exhausted or his contract is terminated. It is certain, however, that with the removal of each ton the stripper is one ton closer to the total which he will recover from the deposit. Hence the value of his interest decreases with each ton of coal produced.

The right of termination may have some relevance to the relative value of the stripper's economic interest, but has no bearing on the existence of that interest in the first instance. This Court is concerned only with the latter question.

Finally, consideration of the precise nature of the right of termination in the present case demonstrates that it cannot foreclose the existence of an economic interest. Subject to Rockhill's right of termination, Parsons had the exclusive right to mine areas allocated to it. It also had the right to mine to exhaustion all the coal which it uncovered, even though the time required to do so was more than ten days. Under such circumstances it is immaterial that its contractual right to uncover additional coal might be terminated. Parsons seeks no depletion allowance with respect to coal as yet uncovered, but only that which it prospected, uncovered and mined. As to such coal, it is conceded that its right to mine was unlimited and exclusive. In fact, as to coal which it uncovered, Parsons' contract was *not* terminable.

B. *The Fact That Parsons Received a Fixed Price Per Ton, Irrespective of the Market Price, Is Irrelevant.*

The Court of Appeals also relied upon the fact that Parsons received from Rockhill a stated price per ton, irrespective of the market price. The Court's reliance upon this factor was a surprising resurrection of an issue which the Department of Justice had apparently conceded in its

brief below [13] and which had apparently been laid to rest by its earlier decision in *Commissioner v. Mammoth Coal Co.*, 229 F. 2d 535 (3d Cir. 1955), *cert. denied*, 352 U. S. 824 (1956).[14] Indeed, on at least two occasions this Court has granted depletion deductions to taxpayers whose interest in the mineral was realized through payments of stated amounts per unit of production. *Bankers Pocahontas Coal Co. v. Burnet*, 287 U. S. 308 (1932); *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364 (1925).

We believe that the view of the Court of Appeals is demonstrably erroneous. It is clear that Congress intended to compensate those who bear the risk of discovery of the mineral. Once the coal is above the ground, the risks are those of sale, a problem inherent in all businesses which does not warrant a special reward. Since the depletion allowance was not intended as a reward for assuming the risks of the market, it is obvious that a coal stripper need not assume the risk of the market in order to receive a depletion deduction. As Judge Kalodner succinctly stated in his dissent in the *Huss* case (*infra*, Appendix A, page 26):

> "Until now, every appellate decision in this type of case, including our own decision in Commissioner of Internal Revenue v. Mammoth Coal Co., supra, has

13. The Department stated its position as follows (Brief, page 18): "When an agreement defines a particular area in which a strip miner is to work and grants to him the exclusive right to mine that area until the mineral supply is exhausted, and provides that all coal mined is to be delivered to the land owner in return for a *stated amount per ton* delivered, it is our position that the miner's relationship with the mineral in place is such as to entitle him to an allowance for depletion." (Emphasis added.)

14. In the *Mammoth* case the Third Circuit had said, 229 F. 2d at 538:

> "The fact that, instead of retaining coal, the stripper received so much per ton for that coal which first had to be offered to and accepted by the [owner] should make no difference, for in any event the stripper had to look to the coal which it mined for return of its investment and profit."

held that there is no requirement that the stripper must assume the risks of the ultimate market." 255 F. 2d at 603.

C. *The Fact That a Portion of Parsons' Investment Was Depreciable Property Suitable for Other Uses Does Not Defeat Its Economic Interest.*

The Court of Appeals relied upon a third factor, which, it said, "deserves separate mention." This factor may be summarized as follows:

> "[P]ercentage depletion . . . is premised on the conception that a tax free recovery of capital actually invested in a wasting mineral deposit is fair . . . . The commitment of capital as an investment . . . must be real and unequivocal."

Otherwise a miner is entitled only to depreciation, and not depletion.

> "[I]t is very doubtful whether investment in equipment of general utility in a contractor's business is the type of capital expenditure which can properly be found to constitute an investment in a particular mineral deposit. . . ." 255 F. 2d at 598-99.

There is a short answer to this. If the Court were correct, no stripper operating under a stripping contract would be entitled to depletion. Almost all stripping equipment can be put to another use and it is all depreciable. Logic compels the conclusion that the Court of Appeals has repudiated all the decided cases, its own included, allowing depletion to coal strippers.

The Court fell into three errors on this point. First, its reference to "capital actually invested" and "capital expenditure" indicates the Court believed that a cash outlay is required to support a depletion deduction. This, of

course, is erroneous. *Commissioner v. Southwest Expl. Co., supra,* 350 U. S. 308 (1956).

Second, the Court considered depreciation and depletion as mutually exclusive. This, too, is obviously erroneous. No one would dispute the proposition that if Rockhill had undertaken the operation as fee owner of the mineral it would have been entitled to deductions for *both* depletion and depreciation. It is likewise obvious that Parsons could not recover the cost of its equipment through depreciation deductions unless it discovered marketable coal and received gross income against which such deductions could be applied.

Third, and most important, the Court failed to comprehend the type of investment involved in the determination of an economic interest and the contribution which Parsons made to the venture. Parsons contributed far more than its tangible property. It staked its entire business operation, including its know-how, payroll and equipment, on the gamble that marketable coal could be discovered and exploited. This was its investment. The fact that it might, just as any oil operator or, indeed, any other businessman, be entitled to depreciation on tangible property is beside the point.

CONCLUSION.

The decision of the Court of Appeals should be reversed.

Respectfully submitted,

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APPENDIX A.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 12,315

No. 12,317

No. 12,319

GEORGE HUSS,
Appellant in No. 12,315

RUSSELL HUSS,
Appellant in No. 12,317

WESLEY HUSS,
Appellant in No. 12,319

v.

FRANCIS R. SMITH, COLLECTOR OF INTERNAL REVENUE,
FIRST DISTRICT OF PENNSYLVANIA

SUR PETITION FOR REHEARING

Present: BIGGS, *Chief Judge;* and MARIS, GOODRICH, STALEY and HASTIE, *Circuit Judges.*

Opinion of the Court

(Filed May 29, 1958)

* * *

KALODNER, *Circuit Judge,* dissenting.

I would grant the petition for rehearing. Further, on rehearing I would reverse the judgment of the district

court on the principal issue involved—the existence of an economic interest.

The Supreme Court has charted the course and the law in cases of this type. Only recently it stated, firmly and concisely, that a taxpayer is entitled to the depletion deduction "where he has: (1) 'acquired, by investment, any interest in the oil in place', and (2) secured by legal relationship 'income derived from the extraction of the oil, to which he must look for a return of his capital' ". Commissioner v. Southwest Exploration Co., 350 U.S. 308, 314 (1956).

"These two factors usually considered together", said the Supreme Court in the Southwest Exploration case, "constitute the requirement of 'an economic interest.' "

Nothing was said by the Supreme Court in that case on the score as to the impact of a right of termination of a contract creating an economic interest on the existence of that interest in the first place. Nor has the Supreme Court said so in any other case. We did not consider nor did we pass upon this question in Commissioner v. Mammoth Coal, 229 F.2d 255 (1955). Nor has any other appellate court done so except the Fourth Circuit. That Circuit, however, has explicitly ruled that a right of termination does not destroy an economic interest which existed prior to its exercise. It did so in two cases: Weirton Ice and Coal Supply Co. v. Commissioner, 231 F.2d 531, 533 (1956) and Commissioner v. Hamill Coal Corp., 239 F.2d 347 (1956).

In Weirton it was said (p. 535):

> "It is of no moment that the owner of the mineral, as in other cases in which the right of an extractor to a deduction for depletion has been upheld, had the option to terminate the arrangement at any time, for as the event proved, Weirton actually mined the coal during all the taxable years."

In Hamill, the contract (entered into in 1944) was to continue for one year and from year to year thereafter with

the right of either party to terminate it at any time upon 90 days' written notice. The contract was terminated in 1947 by mutual agreement "after Daniel [the stripper] had removed substantially all the coal with an overburden of less than 40 feet." (p. 349).

In Weirton the decision does not disclose when mining operation ceased or whether the stripper ever mined to exhaustion. In Hamill, however, the record discloses that subsequent to termination the owner of the mine actually mined some 90,000 tons of coal.

In the instant case it is undisputed that the stripper (taxpayers) mined to exhaustion and that the contracts were terminated by mutual agreement after such exhaustion so that the factual situation here is much stronger than in either Weirton or Hamill.

I agree with the view of the Fourth Circuit that the right of termination does not affect a stripper's right to depletion where the requisite economic interest as defined by the Supreme Court exists. The Commissioner and the courts must deal with a situation as it exists during the taxable year involved and not as it might exist in some future year because of the possible occurrence of an event through the exercise of a contractual right.

It is not necessary, however, that I go as far along the course stated in the decision of the instant case. The record here discloses that the termination clause was included in the contract as a precaution on the part of the owner to protect itself from possible difficulties with an incompetent stripper.[1] It may be noted parenthetically that in the opinion sought to be reconsidered it was erroneously stated "We are not told the reason for including this cancellation clause."

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1. Russell Huss testified (p. 60 N. T.) that the termination clause "was put in there in a form contract so as if they got hold of a contractor who was not reputable, who wouldn't live up to the contract, they could put him off the property without court action."

Assuredly, prior to the exercise of the termination clause, taxpayers here "had an economic interest in the oil [coal] in place through its [their] control over extraction." Burton-Sutton Oil Co., Inc. v. Commissioner, 328 U.S. 25, 34 (1946). That control, moreover, actually existed, as already said, until the property was mined to exhaustion. Further, as stated in Burton-Sutton Oil Co. "Depletion depends only upon production".

It is the possibility of profit from the use of rights over production dependent upon the extraction of the mineral which marks an economic interest. No money need be invested in the mineral deposit. Commissioner v. Southwest Exploration Co., 350 U.S., at page 312.

There is no room for doubt that the taxpayers had the requisite control over production, for under the contracts, the Coal Company gave to taxpayers the exclusive right to mine all of the merchantable coal in place in the leased area. That such right might have been brought to an end does not affect the present fact that the economic interest existed.

There is also no room for doubt that the taxpayers depended solely upon production for their return, since they received only the agreed price per ton for coal produced and delivered. Indeed, they bore all risks of mining, including, but not limited to, the finding and production of commercial quality coal in such quantities necessary to make operation profitable.

Until now, every appellate decision in this type of case, including our own decision in Commissioner v. Mammoth Coal Co., supra, has held that there is no requirement that the stripper must assume the risks of the ultimate market. To the extent that we now hold otherwise, we are in conflict with our decision in that case and with the decisions of the Fourth Circuit. We are also in conflict with the latest pronouncement of the Supreme Court, Commissioner v. Southwest Exploration Co., 350 U.S. at page 314, that the tax-

payer must look solely to the extraction of the mineral for his return. That is what the taxpayers here had to do.

Although we said, in Commissioner v. Mammoth Coal Co., 229 F.2d at page 537, that "The facts in each case determine the result", I do not regard such declaration as an admission that the criteria to be applied are too vague to do so on other than the basis of "the reasonable man". To the facts must be applied statute and the specific rules pronounced by the Supreme Court in the interpretation of it. That is the teaching of Commissioner v. Southwest Exploration Co., supra.

I conclude, therefore, that the taxpayers during the taxable years involved had the requisite economic interest in the coal in place. This, to me, is the result required by the decisions of the Supreme Court, the Fourth Circuit, and this Court; and our present decision is inconsistent therewith.

Accordingly, I would grant rehearing and reverse the judgments of the district court.

APPENDIX B.

Internal Revenue Code of 1939.

§ 23. Deductions from gross income.

In computing net income there shall be allowed as deductions:

* * * * * *

(m) Depletion.

In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for a depreciation of improvements, according to the peculiar conditions in each case * * *.

(n) Basis for depreciation and depletion.

The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in Section 114.

§ 114. Basis for depreciation and depletion.

* * * * * *

(b) Basis for Depletion.

* * * * * *

(4) Percentage Depletion for Coal * * *—(A) In General.

The allowance for depletion under section 23(m) shall be, in the case of coal mines, 5 per centum * * * of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. * * *

(B) Definition of gross income from property.

As used in this paragraph the term "gross income from the property" means the gross income from mining. The

term "mining", as used herein, shall be considered to include not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products. The term "ordinary treatment processes", as used herein, shall include the following: (i) In the case of coal—cleaning, breaking, sizing, and loading for shipment * * *.

Treasury Regulations 111.

§ 29.23(m)-1. Depletion of Mines, Oil and Gas Wells, Other Natural Deposits, and Timber; Depreciation of Improvements. Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. * * * An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.